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Auditing inventories

Anonymous

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those which will suffer no time to be wasted on useless cash work which might be employed to better advantage in reviewing bigger questions. At the same time no fiduciary lapse of recognized size may be permitted to go undiscovered. The public conception of auditing demands that if nothing more.

In considering more effective procedure in the detection of irregularities, it behooves the accountant to give thought to the various ways in which funds may be taken, how such abstractions may be covered up, and how the abstractions with their coverings may be disclosed. With this generalization in mind, nothing will produce good results quite so quickly as a study of each engagement involving a review of the accounts with the object of checking fiduciary integrity. In one case the system of internal check may be so well planned and operated that very little time need be given to detailed auditing. In another case the amount entrusted to an employe at any one time may be so small that if he put the cash box in his pocket and walked out with it the relative effect would be negligible. Again, however, the cash, bank accounts, securities, customers' notes, suspended accounts, bank borrowings, etc., may be all, or in part, in the control of one individual where manipulation is thus encouraged and facilitated and large stealings possible without detection for some length of time.

It is not practicable to lay down hard and fast rules which will fit all cases. It is possible, after studying sufficiently any given case, to decide on procedure which will fit that case. The test of efficiency is that no time has been wasted and any irregularities which existed have been discovered. The public is not so particular about the former. It will brook no shortcomings, pardon no offenses, and accept no excuses with respect to the latter.

Auditing Inventories

INVENTORIES are perhaps the most uncertain element of the balance sheet. For that reason their verification demands the exercise of practical judgment and vision to a greater degree than is usually required with respect to most of the other assets. It may be said that practical business judgment and thorough comprehension of the significance of accounts are essential features of the technical skill required in all auditing, but there is an undeniable tendency to let whatever ability the accountant may possess along those lines lie dormant until the occasion for its application is recognized as having arisen. Some auditing processes are known to demand the fullest possible application of all the accountant's ability, and there are others where, rightly or wrongly, the work is regarded as clerical and therefore requiring only routine consideration.

The verification of inventories is one of the best examples that can be cited of auditing work calling for the utmost possible exercise of the higher class of accounting ability, but very often it is relegated to the minor position of mechanical routine. To be sure, certain parts of the work are clerical, but the tendency is to limit the auditing to that feature and overlook the larger aspects.

It is not intended to discuss at this time the detail procedure of verifying an inventory, but rather to point out some desirable features of auditing that are concerned less with the detailed verification of computations, or even prices, than with the effect of the application of the inventory upon the results of operations. The purpose of investigation in this direction is to supplement the detailed verification of the inventory submitted by the client with a view to determining, as nearly as practicable and along broad lines, whether or not the inventory is reasonably correct in total, and in connection therewith to discover, if possible, the existence and effect of any unusual influences upon costs.

Complete verification of an inventory by the auditor—involving the three features of quantities, prices, and computations—leaves nothing else to be done so far as the determination of the asset value is concerned, although even then some analytical study of the results of operations as affected by the inventories may disclose information of great interest and value to the client. It is, however, unusual for the auditor to make such a complete verification of an inventory. The quantities are comparatively seldom verified and it is often extremely difficult, and sometimes impossible, to substantiate prices to the entire satisfaction of the accountant.

Even with respect to quantities, however, the accountant is seldom barred from exercising his resourcefulness. The fact that an engagement is limited in scope so that the accountant is relieved from responsibility for the quantitative feature of the inventory does not necessarily preclude testing the quantities by physical inspection—even, in some cases, at a considerably later date.

Further, there are many cases where the accuracy, or at least reasonableness, of quantities shown in a physical inventory may be determined by comparison with constructive inventories based upon purchases and sales. These may be maintained by the client or compiled by the accountant; the later will, however, seldom be done unless the merchandise dealt in is uniform and may be expressed in terms of a single unit, e.g., bushels of grain, bales of cotton, pounds of sugar, and machines of a certain type.

With regard to the inclusion in the inventory of obsolete or unsalable goods, there are very few cases where the accountant cannot obtain reasonable satisfaction by inspection or by inquiry of the proper persons.

As to prices, there can be no situation where diligent effort will fail to disclose some means of proof or disproof. The proof may be on the broadest of lines, that is, it may consist of a small part of definite verification and a large part of belief, based upon such verification and the attendant conditions, that an intelligent and honest effort has been made to determine proper values.

Inventory prices are arrived at by some human agency, and it is very seldom that what is done by one person cannot be followed by another. Even though one individual were to compute the prices upon the basis of estimates, and destroy his computations, he should be able to repeat the process in the presence of the accountant as to a sufficient number of items to substantiate the greater part of the inventory valuation and enable the auditor to form an opinion regarding the general propriety of the remainder.

Dismissing the specific features of quantities and prices, we come to the major purpose of this article, which concerns the general review of inventories in relation to their effect upon the operations. It is not intended to discuss the relation of the inventories to other assets, to the capital invested, or to the volume of sales, with a view to determining whether the concern is overstocked or understocked, important as that is in many cases, but merely to bring out some possibilities of procedure in connection with the propriety of the inventory itself.

The effect of the application of inventories is reflected primarily in the cost of goods sold. Cost, however, usually means little except as compared with the proceeds of sales. There is only one condition where cost of itself is interesting in connection with the subject under discussion, and that is where the merchandise dealt in is uniform, or approximately so, and unit or average costs may be computed.

When this condition exists, it may well be worth the effort to compare the unit or average costs resulting from the application of the inventory with the costs for previous periods. If the costs for the current period are appreciably less than for prior periods, the inventory may be overvalued or there may be other causes, but it is incumbent upon the accountant to learn the reason. Conversely, a considerable increase in costs for the current period indicates the necessity of investigation to determine whether the inventory is undervalued or there are other legitimate reasons.

Before proceeding further it may be well to point out that, regardless of the basis of inventory valuation, the result of operation at cost should always be determined; in other words, the cost of the merchandise on hand should be computed, whether or not the inventory is adjusted in accordance with market values. Only in this way can the actual cost of goods sold be ascertained; otherwise, the so-called cost of goods sold is affected by revaluation of the goods unsold.

As previously intimated, the accuracy of the cost of goods sold resulting from the application of the inventory can in most cases be gauged only in its relation to the sales. The principal matter for consideration is, therefore, the ratio of cost to sales, or of gross profit to sales. In the absence of extraordinary conditions the percentage of gross profit should be approximately uniform from year to year.

In any investigation of cost or gross profit full consideration should be given to the possible effect of any abnormal or changed conditions in industry generally and in the specific business particularly. Examples of such conditions are: increased or decreased volume of production or sales (as to quantities), a rising or falling purchase or sale market, disturbed labor or transportation conditions, and inadequate physical control over goods as a safeguard against theft.

A material change in the volume of business will affect the costs whenever overhead expenses enter into cost; this applies particularly to manufacturing concerns. A general change in the price level may or may not have an appreciable effect upon the percentage of gross profit, depending upon whether or not sale prices can be and are adjusted to conform to changing costs.

Sometimes one or more influences such as these are so disturbing to the operations that their effect upon the gross profit cannot even be approximated; in fact there may have been so many influences at work at different times during the period, possibly some favorable and some adverse, that it would be utterly impracticable to attempt to draw any conclusions as to their effect. Such involved situations are, however, rare, especially now that industry has largely recovered from the abnormalities of the war period and general stability has been restored.

There are probably few cases at present where a comparatively short study and well directed inquiries will fail to reveal the existence and approximate effect of any conditions which have had a marked bearing upon the gross profit for a current period of not to exceed a year.

Subject to the possible effect of such conditions as have been cited, the percentage of gross profit resulting from the application of the inventory should be reasonably consistent with the experience of prior periods—considering, of course, the possibility of the prior operations being also affected by extraordinary influences. Any considerable disparity in the operating ratios which is not otherwise explained must be due to error in the inventory at either the end or the beginning of the period—assuming, of course, that the sales and purchases have been found to be correctly stated.

In such a situation, if the inventory at the beginning of the period has not been previously verified it should be examined along broad lines and comparisons should be made of the larger items thereof with the corresponding items of the inventory at the end, in respect of both quantities and prices. If it appears after such examination that the inventory at the beginning is substantially correct there is nothing left to do but subject the inventory at the end to the most detailed examination practicable and possibly to obtain a certificate as to the accuracy of the inventory from responsible officials. Failing any satisfactory explanation of an apparent overstatement or understatement of the inventory, the matter should be commented upon at length in the report.

More About Inventories

IN relating this incident it is with a spirit of thankfulness rather than of fiendish glee that we preface the remarks with a statement to the effect that this did not happen to us.

The story runs as follows:

A certain firm of well-known, reliable, and conscientious accountants was retained to make an investigation involving the taking, pricing, and extending of an inventory of a concern whose business was about to be sold. In accordance with the engagement, the physical inventory was taken by the staff of the public accountants, quantities were checked and rechecked, prices were obtained with utmost care, and the work of extending and establishing the total value of the inventory was carried on by the accountants assigned to the engagement.

During the course of this work, quantities, articles, and prices were listed on sheets, which sheets were distributed among the accountants in the party who made the calculations necessary to the establishment of the results.

While the work of preparing the sheets was going on, employes of the company, gaining access to the sheets during the lunch hour, proceeded to insert on the sheets in front of figures already appearing thereon additional figures, which changed entirely many of the quantities and prices. For example, where the quantity of a certain article appeared originally as 1,000, a figure one was inserted in front of the original figure so as to make it appear as 11,000 instead of 1,000. Similar changes were made in prices so that a price appearing originally as 23 cents was made to appear as $11.23.

As a result of these changes, which had been so skilfully made as not to be discovered at the time of calculation, the inventory is said to have been overvalued in excess of $1,000,000.

There are a number of questions raised by this incident: